DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

OFFICE OF
CHIEF COUNSEL

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INTERNAL REVENUE SERVICE NATIONAL OFFICE FIELD SERVICE ADVICE

MEMORANDUM FOR

FROM: M. Grace Fleeman
Assistant to the Branch Chief CC:INTL:BR1

SUBJECT:

This Field Service Advice responds to your memorandum dated May 21, 1999. Field Service Advice is not binding on Examination or Appeals and is not a final case determination. This document is not to be used or cited as precedent.

<u>LEGEND:</u>

A	=	
B	=	
C	=	
D	=	
E	=	
F	=	
Country G	=	
Trust 1	=	
Trust 2	=	

Date 1	=	
Date 2	=	
Fund 1	=	
Fund 2	=	
Corporation V	=	
Corporation W	=	
Corporation X	=	
Corporation Y	=	
Corporation Z	=	

ISSUES:

1. Whether A and his spouse B should be treated as owners of Trust 1 and Trust 2 under the grantor trust rules (sections 671 through 679), with the result that they are treated for purposes of subpart F (sections 951 through 964) as owners of the stock that is owned indirectly by Trust 1 and Trust 2.[1]

2. Assuming A and B are not treated as owners of Trust 1 and Trust 2 under the grantor trust rules, whether the stock of Corporations X and Y that is owned indirectly by Trust 1 and Trust 2 should be considered to be owned by A either indirectly under section 958(a) or constructively under section 958(b).

[1] Unless otherwise indicated, all references to "section" are to sections of the Internal Revenue Code of 1986, as amended ("Code").

CONCLUSIONS:

1. Based on the facts available to us at this time, it appears that A and B should not be treated under the grantor trust rules as the owners of any portion of Trust 1 or Trust 2.

2. Under the indirect ownership rules of section 958(a), it appears that A should be treated as an indirect United States shareholder of Corporations X and Y. In light of this conclusion, it is not necessary to ascertain A's constructive ownership interest under section 958(b).

FACTS:

A and his wife B are U.S. citizens. A and B are beneficiaries of Trust 1. Trust 1 is the beneficiary of Trust 2. Trust 1 and Trust 2 were formed under the laws of Country G on Date 1 and Date 2, respectively.

The initial transfers of funds to Trust 1 and Trust 2 were made by F, who is believed to be neither a citizen nor a resident of the United States. We do not know if F was reimbursed by any party. We also do not know if any party other than F has made gratuitous transfers to Trust 1 or Trust 2.

A is the Protector of Trust 1 and Trust 2. Clause 16 (a) of the Declaration of Trust for each trust provides the Protector with the power to approve or veto virtually all actions taken by the trustees. Clause 16 (b) provides that the Protector shall not have the power to vest in himself, his creditors, his estate, or the creditors of his estate any portion or all of the capital or income of the Trust Fund or to have any incidents of ownership with respect thereto.

The Trust Periods of Trusts 1 and 2 are set out in Clauses 1(xii) and 1(xi) of the respective Declarations of Trust. The Trust Period of each trust is not to exceed 100 years from the date of settlement and may terminate earlier for a variety of reasons, including the distribution of all the trust's capital and income.

Clause 4(a) of the Declaration of Trust for Trust 1 provides that all the trust's net income is to be paid to A during his lifetime or to such person or persons as he may from time to time direct. (It is understood that during the taxable years in issue, A did not exercise his authority to direct trust income to any other person under this clause.) Clause 4(b) provides that upon A's death, the trustees shall divide the capital and remaining income of Trust 1 into two equal half shares, Fund 1 and Fund 2. If B survives A, the whole net income of Fund 1 is to be paid to B during her lifetime. On her death, the whole net income of Fund 1 is to be paid to members of a specified class of beneficiaries named in Clause 1(vi), which class includes A's and B's issue, any surviving spouse of A or B, C and D (understood to be children of A and/or B), and

C's and D's surviving spouses (if any), in such proportions and for such periods as B shall appoint. (The persons described in clause 1(vi) are referred to below as collectively the "Specified Class.") If B fails to exercise this power, the net income is to be paid to the Specified Class members in equal shares. Notwithstanding any provision in Trust 1 to the contrary, B is precluded from vesting in or appointing to herself, her creditors, her estate, or the creditors of her estate, any of the capital or income of the trust fund. (See clause 4(b)(vi), relating to Fund 1.)

After A's death, the whole net income of Fund 2 is to be paid to members of the Specified Class, in such proportions and for such periods as A shall have appointed, or, failing such appointment, in equal shares. Notwithstanding any provision to the contrary, A is precluded from vesting in or appointing to himself, his creditors, his estate, or the creditors of his estate, any of the capital or income of the trust fund. (See clause 4(b)(v), relating to Fund 2.)

In both Fund 1 and Fund 2, provision is made for deceased members of the Specified Class who leave heirs, so that such heirs will take in equal shares, per stirpes, in the absence of any contrary appointment by B or A, respectively.

Upon the expiration of the Trust Period, the remaining capital and income of Fund 1 and Fund 2 shall be distributed to then living members of the Specified Class as B and A, respectively, shall have appointed, or, failing such appointment(s), in equal shares.

It is not clear whether all the named members of the Specified Class are United States citizens or residents. Although it appears (solely from their last names) that C and D have both been married, it also is unclear at this time whether they remained married during the years in issue, and, if so, whether their spouses were United States citizens or residents.

Until the deaths of A and B, all of Trust 2's net income is to be paid to Trust 1. After the deaths of A and B, Trust 2 is to distribute all its capital and income to Trust 1.

Trust 2 is understood to own 100 percent of the stock of two foreign corporations, Corporation V and Corporation W. Corporations V and W own 10 percent of the stock of two other foreign corporations, Corporation X and Corporation Y. We understand that Corporations V, W, X, and Y each have only one class of issued and outstanding shares.

A's brother E, who is understood to be a United States citizen or resident, directly or indirectly owns 10 percent of each of Corporations X and Y. Corporation Z, a United States corporation, owns 35 percent of each of Corporations X and Y. You have determined that if A and B are treated as the owners of the Corporation X and Y stock that is owned indirectly by Trusts 1 and 2, A and B will be United States shareholders within the meaning of section 951(b) and Corporations X and Y will be controlled foreign corporations within the meaning of section 957.

LAW AND ANALYSIS -- ISSUE 1

You have asked whether A's powers as Protector of Trusts 1 and 2 cause A and B to be treated as the owners of Trusts 1 and 2 under the grantor trust rules. If A and B are treated as the owners of Trusts 1 and 2 under the grantor trust rules, any stock that is owned, directly or indirectly, by Trusts 1 and 2 is considered to be owned by A and B for purposes of subpart F. *See* Treas. Reg. §1.958-2(c)(1)(ii)(b).

Section 671 provides that where a grantor or another person is treated as the owner of any portion of a trust under the grantor trust rules, there shall be included in computing the taxable income and credits of the grantor or the other person those items of income, deductions, and credits against tax of the trust that are attributable to that portion of the trust to the extent that such items would be taken into account in computing taxable income or credits against the tax of an individual. Section 671 further provides that no items of a trust shall be included in computing the taxable income and credits of the grantor or of any other person solely on the grounds of his dominion and control over the trust under section 61 (relating to definition of gross income) or any other provision of this title, except as provided in the grantor trust rules.

Sections 673 through 677 define the circumstances under which a grantor of a trust is treated as an owner of any portion of the trust. The term "grantor" includes any person to the extent such person either creates a trust, or directly or indirectly makes a gratuitous transfer of property (including cash) to a trust. *See* Treas. Reg. §1.671-2T(e)(1). A gratuitous transfer is any transfer other than a transfer for fair market value. *See* Treas. Reg. §1.671-2T(e)(2)(i).

Section 679(a) provides generally that a United States person who directly or indirectly transfers property to a foreign trust (other than a trust described in section 6048(a)(3)(B)(ii), an exception that is not applicable here) shall be treated as the owner for his taxable year of the portion of such trust attributable to such property if for such year there is a United States beneficiary of any portion of such trust.

Section 678(a) provides that a person other than the grantor (or a transferor to whom section 679 applies) is treated as the owner of any portion of a trust with respect to which (1) such person has a power exercisable solely by himself to vest the corpus or the income therefrom in himself, or (2) such person has previously partially released or otherwise modified such a power and after the release or modification retains such control as would, within the principles of sections 671 to 677, inclusive, subject a grantor of a trust to treatment as the owner thereof.

Based upon the facts available to us at this time, it appears that A and B are not grantors of any portion of Trust 1 or Trust 2, because A and B neither created the trusts nor made any gratuitous transfers to the trusts. Accordingly, A and B cannot be treated as owners of any portion of either trust under sections 673 through 677. This is true despite the fact that A is the current income beneficiary of Trust 1 and has the power to control the actions of the trustees.

Similarly, the facts available to us do not support treating A and B as owners of any portion of either trust under section 679, because neither A nor B has directly or indirectly transferred property to either trust.

It also appears that A and B cannot be treated as owners of any portion of either trust under section 678, because A does not have a power exercisable solely by himself to vest the corpus or the income from either trust in himself, nor does it appear that A has ever previously partially released or otherwise modified such a power.

Although we cannot conclude based on the facts available to us at this time that A and B should be treated as owners of Trusts 1 and 2 under the grantor trust rules, we note that F created and funded Trusts 1 and 2 with only a nominal amount. Subsequent substantial funding of the trusts presumably needed to occur to enable the trusts to invest in the corporations. Some of the funding may have come from A and B. Where settlors only nominally fund a trust they create, and other persons make large gratuitous transfers to the trust, the subsequent transferors may be considered grantors for purposes of the grantor trust rules. *See Bixby v. Commissioner*, 58 T.C. 757, 791 (1972), *acq.*, 1975-2 C.B. 1. *See also* Treas. Reg. §1.671-2T(e)(1).

We also note that F may have acted as A's agent by creating and funding the trusts on A's behalf. In particular, if the facts reveal that F was a strawman, or that F set up the trusts so that A would not be treated as the grantor, or that any property contributed to the trusts originated with A, then A could be considered the grantor of the trusts for purposes of the grantor trust rules.

<u>LAW AND ANALYSIS -- ISSUE 2:</u>

Even if A and B are not treated as owners of Trusts 1 and 2 under the grantor trust rules, their status as beneficiaries of Trusts 1 and 2 may nevertheless cause them to be treated as owners of stock that is owned indirectly by Trusts 1 and 2.

Section 951(a) provides that if a foreign corporation is a controlled foreign corporation ("CFC") for an uninterrupted period of thirty days or more during a taxable year, every person that is a United States shareholder and that owns (directly and indirectly under section 958(a)) stock in the foreign corporation on the last day of the taxable year in which it is a CFC must include in gross income his pro rata share of the CFC's subpart F income.

Section 951(b) defines a United States shareholder as a United States person who owns, directly or indirectly, under section 958(a), or constructively, under section 958(b), 10 percent or more of the total combined voting power of all classes of stock entitled to vote.

Section 957(a) defines a CFC as any foreign corporation if more than 50 percent of the total combined voting power of all classes of stock entitled to vote, or of the total value of the stock, is owned, within the meaning of section 958(a) or (b), by United States shareholders on any day during the taxable year of the foreign corporation.

Section 958 provides rules for determining stock ownership. For purposes of subpart F (other than section 960(a)(1), not here relevant), section 958(a)(2) provides that stock owned directly or indirectly by a foreign trust is considered as owned proportionately by the trust's beneficiaries, and stock owned by a foreign corporation is considered as being owned proportionately by its shareholders. Stock considered to be owned by a trust or corporation under this rule is treated as actually owned by the beneficiary or shareholder for purposes of determining further indirect ownership.

Treas. Reg. §1.958-1(c)(2) provides in part that for purposes of section 958(a), the determination of a person's proportionate interest in a foreign trust will be made on the basis of all the facts and circumstances in each case. Generally, in determining a person's proportionate interest in a foreign corporation, the purposes for which the rules of section 958(a) are being applied will be taken into account. Thus, if the rules of section 958(a) are being applied to determine the amount of stock owned for purposes of section 951(a), a person's proportionate interest in a foreign corporation will generally be determined with reference to such person's interest in the income of such corporation. If the rules of section 958(a) are being applied to determine the amount of voting power for purposes of section 951(b) or 957, a person's proportionate interest in a foreign corporation will generally be determined with reference to the amount of voting power in such corporation owned by such person. Any arrangement that artificially decreases a United States person's proportionate interest will not be recognized.

Section 958(b) provides constructive ownership rules for subpart F. Section 958(b) provides in part that for purposes of sections 951(b) and 957, section 318(a) (with certain modifications) shall apply to the extent that the effect is to treat any United States person as a United States shareholder for purposes of section 951(b) or to treat a foreign corporation as a CFC under section 957.

Treas. Reg. §1.958-2(c)(1)(ii)(a), construing section 951(b), provides that stock owned directly or indirectly by a trust (other than certain exempt employees' trusts) shall be considered as owned by its beneficiaries in proportion to the actuarial interest of such beneficiaries in such trust. Treas. Reg. §1.318-3(b), elaborating upon this rule, states that accordingly, the income of income beneficiaries, remainder beneficiaries, and other beneficiaries will be computed on an actuarial basis. The factors and methods prescribed in Treas. Reg. §20.2031-7 (Estate Tax Regulations) for use in ascertaining the value of an interest in property for estate tax purposes shall be used in determining a beneficiary's actuarial interest in a trust for purposes of Treas. Reg. §1.318-3.

Treas. Reg. §1.958-2(f)(2) provides that for purposes of any one determination, stock that may be owned under more than one of the rules of Treas. Reg. §§1.958-1 and -2, or by more than one person, shall be owned under the attribution rule that imputes to the person, or persons, concerned the largest total percentage of such stock.

If, by reason of their interests as indirect and direct beneficiaries of Trust 2 and Trust 1, respectively, A and B are treated as either indirectly or constructively owning all of the stock of Corporations X and Y that is indirectly owned by Trust 2, then their ownership interest -- exactly 10 percent of the total issued and outstanding shares of each of those corporations -- would cause A and B to be treated as United States shareholders of such corporations under section 951. In that case, each of Corporations X and Y would, during the years at issue, be a CFC, because 55 percent of each corporation's stock would be considered as owned by United States shareholders. Thus, treating A and B as either indirect or constructive shareholders of Corporations X and Y could cause other United States persons who are direct or indirect United States shareholders of Corporations X and Y to be subject to tax on their pro rata share of such corporations' subpart F income. *See* Code §951(a)(2). Further, if A and B are treated as indirectly owning such shares under section 958(a), rather than constructively under section 958(b), A and B also may be subject to tax on their pro rata share of the corporations' subpart F income pursuant to section 951(a)(2).

Regulations under section 958(a)(2) do not address directly how to determine beneficiaries' proportionate interests in stock owned, directly or indirectly, by or for a foreign trust, except in a simple fact pattern. Treas. Reg. §1.958-1(d), Ex. (*3*), describes a foreign trust, the income of which is to be divided into three equal shares. Each beneficiary's share of the income may be accumulated for him or distributed to him in the discretion of the trustee. Upon termination of the trust, each beneficiary is to receive one-third of the corpus and the accumulated income applicable to his share. The trust owns 90 percent of the one class of stock in a foreign corporation. Under these circumstances, each beneficiary is treated as owning 30 percent of the stock of that corporation.

Although certain other provisions of the Code contain language identical to that in section 958(a)(2), and have been construed by the Service or the courts, the relevance of those provisions to determinations required to be made under section 958(a)(2) is at best questionable, as the purpose for which indirect ownership is being ascertained differs in each case. For that reason, we believe that even though the Service has construed statutory language identical to that in section 958(a)(2) regarding the indirect ownership of stock through a trust, those analyses are unhelpful in the present inquiry. *See* Rev. Rul. 62-155, 1962-2 C.B. 132 (in which the present and remainder beneficiaries of a trust were considered to own stock owned by the trust based on their actuarial interests therein, for purposes of former section 421(d)(1)(C) and section 544(a)(1)), *revoking* Rev. Rul. 58-325, 1958-1 C.B. 212 (holding that only present interests should be taken into account for this purpose). Similarly, judicial constructions of the same or similar language, used in different provisions of the Code for various, non-subpart F purposes, also are unhelpful. *See, e.g., Phinney v. Tuboscope Co.*, 268 F.2d 233 (1959), and *Steuben Securities Corp. v. Commissioner*, 1 T.C. 395 (1943) . This is especially so because for purposes of section 958, section 958(b) and Treas. Reg. §1.958-2(c)(1)(ii) expressly determine constructive ownership with reference to actuarial interests (as do regulations under section 318), thereby suggesting that section 958(a)(2) and Treas. Reg. §1.958-1(c)(2) need not mandate application of the same rule.

Our view of the relevance of these interpretations of the same or similar language in other Code sections to the appropriate construction of 958(a)(2) is bolstered by *Hickman v. Commissioner*, T.C. Memo. 1972-208. At issue in *Hickman* was whether the petitioners, husband and wife, owned, within the meaning of section 267, more than 50 percent of the value of the outstanding stock of a corporation, Atlas Groves, Inc., so that Atlas could not claim under section 179 an investment tax credit with respect to property purchased from the Hickmans. The petitioners did not directly own any stock in Atlas, but were the two income beneficiaries of a trust that owned all of Atlas' stock. Although petitioners relied "strongly" on Rev. Rul. 62-155, *supra*, to argue that their interest in the trust should be determined on an actuarial basis, the court determined "that Congress did not intend that [it] should look for parallel terminology in unrelated sections of the Code" to ascertain "value" for purposes of section 267. In the absence of any indication in the legislative history that a cross-reference to interpretation to section 267 was intended, the court declined to fashion one. In concluding that the stock owned by the trust should not be valued for purposes of section 267 on the basis of actuarial principles, the court disallowed the investment tax credit at issue. The court also rejected an alternative argument that general valuation principles such as those used in the estate tax regulations should be used to value the Hickmans' interests in the trust. Use of those principles would have reduced the value of the Hickmans' interest to zero because of limitations imposed under the trust agreement.

In light of the foregoing, we conclude that for purposes of section 958(a)(2) and Treas. Reg. §1.958-1(c)(2), where a foreign non-grantor trust provides for distribution of all of the trust's net income to one or more named individuals in specified proportions, or (as here), where the trust provides that all its net income should be distributed to a single named individual, the trust's income beneficiaries should be treated as proportionately owning stock owned, or considered as owned, by the trust. Under these circumstances and for this purpose, remainder beneficiaries, whether vested or contingent, should not be taken into account.

Our conclusion supports the purpose of subpart F, which is to avoid the deferral of certain classes of income earned by CFCs by requiring such amounts to be annually included in income by the United States shareholders thereof. Our conclusion also is generally consistent with PLR 8748043 (September 1, 1987), which dealt with the subpart F consequences of an interest in a Netherlands usufruct and, without citing Rev. Ruls. 62-155 or 58-325, concluded that the usufructuary should be considered as owning foreign corporate stock subject to a usufruct interest. The ruling specifically noted that the facts therein supported the conclusion that the usufruct was not an arrangement to decrease artificially a United States person's proportionate interest in the foreign corporation.

Applying the foregoing determination to the facts before us, we conclude as follows: First, Corporations V and W are treated as owning 10 percent of the stock of Corporations X and Y, respectively, under section 958(a) and Treas. Reg. §1.958-1(c)(2). Second, Trust 2 is treated as indirectly owning the 10 percent interests in Corporations X and Y that are directly owned by Corporations V and W, because Trust 2 owns 100 percent of the stock of Corporations V and W. Third, Trust 1 is considered as owning all of the interests in Corporations X and Y that are owned by Trust 2, because Trust 1 is the sole income and remainder beneficiary of Trust 2. Finally, A and B, who are United States persons, are treated as owning the 10 percent of the stock of Corporations X and Y that is, under the preceding analysis, considered as owned by Trust 1. Accordingly, A and B are United States shareholders of Corporations X and Y, and are required to take into account their 10 percent interest in the subpart F income of Corporations X and Y.

It should be further noted that, under the terms of Trust 1, A may direct that the trust's net income be paid to one or more other persons. It is possible that pursuant to this clause, A could direct that a small portion of his income interest be paid to a United States person who is not a United States shareholder of Corporations X and Y or to a foreign person. If A were to do so, it might become necessary to determine whether the disposition of that income interest might constitute, under Treas. Reg. §1.958-1(c)(2), an arrangement that artificially decreases a United States shareholder's proportionate interest in those corporations, and so will not be recognized.

Because we conclude that A and B indirectly own 10 percent of the stock of Corporations X and Y, it is not necessary at this time to determine the amounts A and B are deemed to own constructively, applying actuarial principles, for purposes of section 951(b). *See* Treas. Reg. §1.958-2(f)(2).

CASE DEVELOPMENT, HAZARDS AND OTHER CONSIDERATIONS:

[redacted]

[redacted]

If you have any further questions, please call (202) 622-3880.

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